No. 9812

In the United States Circuit Court of Appeals for the Ninth Circuit

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L. B. Hirsch and Max S. & Clementine Hirsch,
PETITIONERS

v.

Commissioner of Internal Revenue, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
J. LOUIS MONARCH,
BERNARD CHERTCOFF,
Special Assistants to the Attorney General.

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OPINION BELOW

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 41-69) reported at 42 B. T. A. 566.

JURISDICTION

This case involves income taxes of Max S. Hirsch and Clementine Hirsch for the year 1935, and income taxes of L. B. Hirsch for the years 1935 and 1936. The decisions of the Board of Tax Appeals were entered on September 19, 1940. (R. 70-71.) The petition for review was filed on December 16, 1940. (R. 79-80.) The jurisdiction of this Court rests upon Sections 1141-1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

I

Whether there is substantial evidence to sustain the finding of the Board of Tax Appeals that the cancellation in 1935 of debts owed to a corporation by its stockholders and redemption of a portion of its capital stock was essentially equivalent to the distribution of a taxable divided.

II

Whether there is substantial evidence to sustain the finding of the Board of Tax Appeals that one of the taxpayers failed to prove that a debt due to him had become worthless in 1935.

III

Whether there is substantial evidence to sustain the finding of the Board of Tax Appeals that one of the taxpayers failed to prove that he was the head of a family and had three dependents.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and other authorities involved are set out in the Appendix, *infra*, pp. 30–35.

STATEMENT

Taxpayers Max S. Hirsch and his wife, Clementine Hirsch, filed a joint return for the year 1935. (R. 43.) They are concerned only with the issues presented under questions I and II. Taxpayer L. B. Hirsch is

a brother of Max S. Hirsch. (R. 43.) He is concerned only with the issues presented in questions I and III. The facts, which are taken from the findings of fact by the Board and the statement of evidence stipulated by the parties (R. 81, 169), are as follows:

I

During 1935 and 1936 Max S. Hirsch and L. B. Hirsch were president and vice president, respectively, of the Hirsch-Weis Manufacturing Company. This corporation, which was engaged in the business of manufacturing and selling work clothes, canvas materials and related products, was organized under the laws of the State of Oregon in 1912. Its principal place of business was in Portland. (R. 43.) Its authorized capital stock at organization was $100,000, divided into 1,000 shares of common stock of $100 par value. Of the original stock issue, Max S. Hirsch held 600 shares, L. B. Hirsch 160 shares, Clara Behrens, sister of the Hirsch brothers, 40 shares, H. A. Weis 100 shares, and E. A. Gerst 100 shares. (R. 43–44.) On or about December 20, 1920, the authorized capital stock of the company was increased to 7,000 shares of $100 par value each and a 500 percent stock dividend was declared and paid. At or about that time seven shares were issued to a son of Max S. Hirsch, 34 shares to a nephew and 12 shares to a niece. (R. 44.) The stockholders and the number of shares held by each on

December 21, 1920, and on December 20, 1935, were as follows (R. 44):

Stockholder	Shares owned Dec. 21, 1920	Shares Owned Dec. 20, 1935
Max S. Hirsch	3,600	3,600
L. B. Hirsch	960	1,000
H. A. Weis	600	634
E. A. Gerst	600	598
Clara Behrens	240	74
H. Minsch	34	34
E. Doering	12	12
H. Hirsch	7	7
Total	6,053	5,959

Max S. Hirsch had been president and general manager of the corporation since its formation. For a number of years he and his brother, L. B. Hirsch, had been in the habit of borrowing large sums of money from the company, some on open account and some on promissory notes. These notes bore interest at the rate of six percent. (R. 44.) From time to time the brothers repaid the loans with interest, out of dividends received from the company. The total indebtedness of officers and employees to the company on December 31, 1934, was $54,859.44, nearly all of which was owed by the two principal stockholders, the brothers Hirsch. (R. 45.) On January 1, 1935, Max S. Hirsch owed the company $47,100. On December 20, 1935, his total indebtedness to the company amounted to $58,010.51, of which amount $41,100 was represented by his promissory notes, $13,123.10 was on open account, $1,287.41 was accrued interest and $2,500 was represented by a note of a third party which he had assumed. On December 14, 1935, L. B. Hirsch owed the company $14,-

186.18, which amount was still due to the company on December 20, 1935, and was all represented by promissory notes. (R. 45.)

Prior to June, 1934, the company had made a practice of borrowing money for operations from banks and had paid interest at the rate of five to six per cent therefor. In 1934 it began to sell its commercial paper on the open market through brokers and was able to secure money by this means at rates of one to one and a quarter per cent. The brokerage concern which was marketing the company's commercial paper recommended that the indebtedness of the stockholders to the company be liquidated in order to protect the company's financial rating. (R. 45–46.) The directors [Max S. Hirsch, L. B. Hirsch and H. A. Weis constituted the board of directors (R. 89)] after informal discussion decided on or shortly prior to December 21, 1935, that the brothers Hirsch should pay off their indebtedness to the company by turning in ten per cent of their stock at its par value of $100 per share. The other stockholders were to have the same privilege. On December 21, 1935, Max S. Hirsch surrendered 500 shares of his stock and L. B. Hirsch surrendered 100 shares of his stock in partial liquidation of their loans. Two other stockholders turned in 26 shares during 1935 and subsequently additional shares were turned in by other stockholders under this same arrangement. (R. 46, 101.)

In the company's books closing journal entries were made under date of December 31, 1935, showing a debit of $62,600 to "Treasury Stock" and a credit of a like amount to "General Ledger", with the notation "To

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take up charges from General Ledger." Also there was a debit to "Capital Stock" of $62,600 and a corresponding credit to "Treasury Stock", with the notation "To show cancellation of Stock." (R. 46–47.)

No minutes of the informal meeting held on or about December 21, 1935, were made, but about two years later minutes bearing the date of December 21, 1935, were prepared and posted in the company's books. The relevant portion of these minutes reads as follows (R. 47–48):

* * * * *

> The president called attention to the indebtedness to the corporation of L. B. Hirsch and Max S. Hirsch and stated that there was no other way at this time or in the near future that this indebtedness be paid by either debtor excepting to sell to the corporation, part of their respective holdings of shares in the corporation.
>
> After a great deal of discussion, it was moved, duly seconded, and carried that said L. B. Hirsch and Max S. Hirsch sell to the corporation, 10% of its shares of stock in the corporation at a par value of $100.00 per share, giving the same privilege to each and every stockholder who desires to take advantage of it now or anytime in the future—that is 10% of their holdings in the corporation, as of Dec. 21, 1935.
>
> As 10% of the holdings of shares of stock in the corporation of said Max S. Hirsch would not pay the complete indebtedness with interest and a certain note of John Schibel that said

Max S. Hirsch assumed, it was moved, seconded and carried that the corporation buy from said Max S. Hirsch an additional 4% or a total of approximately 14% of said Max S. Hirsch holding of shares of stock in the corporation which would then pay the complete indebtedness to the corporation with interest as well as the note referred to. * * *

From 1913 to 1935 the company operated at a substantial profit in each year except for the years 1930, 1931 and 1932. (R. 49.) The company's balance sheets showed undivided profits on December 31, 1933, of $86,322.54; on December 31, 1934, of $125,891.17, and on December 31, 1935, of $150,924.34. (R. 50.) The company paid dividends from 1914 to 1928, inclusive, except for the year 1921. Although the principal shareholders borrowed large amounts (R. 53) from the company between 1930 and 1934, no dividends were paid after 1928, except for the distribution held taxable as such by the Board in this case. The by-laws of the company provided that "A dividend of not less than six per centum of the par value of the capital stock of the corporation shall be declared annually * * *" provided earnings were available. At the time of the hearing the word "may" was written in in pen and ink over the word "shall". (R. 106.) Max S. Hirsch testified he had made the change in 1929 or prior thereto, but admitted that he did not have authority to do so either from the board of directors or from the stockholders. (R. 106–107.) Eric P. Van who had audited the com-

pany's books in 1935 (R. 121) testified that at that time the above-mentioned change had not yet been made in the by-laws and that the by-laws read that a six per cent dividend *shall* be declared annually (R. 122).

In his income tax return for 1935, Max S. Hirsch treated the surrender of the stock to the corporation as a capital transaction. The Commissioner determined that the transaction had resulted in the payment of a dividend to Max S. Hirsch. (R. 50–51.) The same determination was made in the case of L. B. Hirsch who had not reported the transaction in his return at all. (R. 51.)

The Board of Tax Appeals found as a fact that the redemption of stock occurred at such time and in such manner as to make the redemption essentially equivalent to the distribution of a taxable dividend.

II

In 1925 Max S. Hirsch lent his brother-in-law, Leo W. Seller, $15,000 to invest in a business of manufacturing house dresses. This business was organized at or about that time by Seller and one Sol Garde under the name of the Garde-Seller Company. The loan was evidenced by a promissory note and was secured by Seller's stock in the company. Interest was paid on the note regularly to September 1, 1930. In 1932 the Garde-Seller Company (then known as the Leman-Seller Manufacturing Company) became insolvent and was placed in liquidation. Seller's share of the proceeds from the liquidation were turned over to Max S.

Hirsch to apply against the note. (R. 56.) These proceeds were as follows:

1932	$4,155.00
1933, first half year	1,050.00
1933, second half year	268.84
1934, Jan. 1 to Apr. 4	10.00
1934, Apr. 5 to July 25	36.92
1934, July 26 to Oct. 15	10.00
Total	5,530.76

No further payments on principal or interest were ever received by Hirsch. (R. 57.)

On May 9, 1934, the law firm in charge of the liquidation of the Leman-Seller Manufacturing Company wrote to the taxpayer stating that the only remaining assets of the company were "collection items of uncertain value." (R. 57.) On November 9, 1935, the taxpayer wrote the following letter to one of the attorneys in the liquidating firm (R. 57–48):

Nov. 9, 1935.

Mr. Edward G. Dobrin,
c/o Bogle, Bogle & Gates,
6th Floor Central Bldg.,
Seattle, Wn.

Dear Mr. Dobrin: On May 9, 1934 you advised me that there was some remaining assets of uncertain value which Mr. Schermer agreed to describe in a letter to you and to divide the net recoveries three-eighths and five-eighths as collected.

I have never heard about these remaining assets up to date, either about all of them or any part so I would appreciate it if you would investigate and advise if there is any possible chance for any additional recoveries.

My loss in advancing or loaning money to Mr. Seller is not yet ascertained and as I wish to do so by the first of the year so that I can take my loss into consideration when making up my income tax statement, I would appreciate it if you would write me in detail.

Be kind enough to word your letter in such a way that the Federal State and Tax Commission do not question the deduction of my loss nor do they take a position that this loss should have been charged off the year previous.

I am sure you will understand to what I refer and thank you in advance.

With kindest personal regards, I am

Yours truly,

MSH: MD

The following reply to the above letter was received by the taxpayer under date of December 10, 1935 (R. 58–59):

SEATTLE, *December 10, 1935.*

Mr. MAX S. HIRSCH,
67 West Burnside Street,
Portland, Oregon.

DEAR SIR: On May 9, 1934 we advised you that the only remaining assets of Leman-Seller Manufacturing Company are collection items of uncertain value which Mr. Schermer agreed to describe in a letter to us and to divide the net recovery three-eighths and five-eighths as collected.

Mr. Schermer has failed to give us the letter requested and although often requested to do so, has failed to give us any report. We wrote to him in this connection without response from him, under dates of October 12, 1934, January 15, 1935, February 26, 1935, March 26, 1935 and August 17, 1935.

Under the circumstances, we believe that you may consider that no further recovery will be forthcoming.

Very truly yours,

[Signed] BOGLE, BOGLE & GATES.

After the liquidation of the Leman-Seller Manufacturing Company was begun in 1932, Seller worked as a traveling salesman until the latter part of 1935, when he suffered a slight stroke. He was able to return to his work after several weeks but never fully regained his health. His net earnings in 1934 and up to the time of his illness in 1935 were from about $2,400 to $2,800 per year. He had no property in either year out of which his indebtedness to the taxpayer might have been paid. (R. 59.)

The taxpayer knew or had reason to believe that the unpaid balance of Seller's indebtedness to him at the close of 1934 was uncollectible. (R. 59.)

III

L. B. Hirsch in his return for 1935 and 1936 claimed a personal exemption of $2,500 as head of a family and a credit of $1,200 for three dependents. The Commissioner disallowed the credit for the dependents and allowed the taxpayer a personal exemption of only $1,000. (R. 63.) The taxpayer is unmarried. Since 1922 he has resided with his sister, Eda H. Low, her husband, Julius Low, and their daughter Barbara. These three persons were of the ages, in 1935, of approximately 55, 60 and 15 respectively. (R. 64.) The home in which these people resided had been purchased by the taxpayer and given to his sister as a gift in

1922. In 1932 or 1933 the property was mortgaged to secure a loan to the taxpayer of $10,000, which taxpayer subsequently paid off. During the years 1935 and 1936 the taxpayer contributed about $350 or $400 per month to the general expenses of maintaining the household. In addition, the taxpayer paid medical bills and contributed to the educational expense of Barbara. Julius Low's earnings have amounted to approximately $400 or $500 per year since 1929 or 1930 when he suffered a permanent impairment of his eyesight. (R. 64–65.) During 1935 and 1936 the taxpayer and the Lows owned all the stock of the Hirsch Investment Company. On December 31, 1935, the taxpayer owned 27½ shares and the Lows owned 22½ shares of the stock of this company. The company's principal asset was a parcel of improved real estate which was rented. (R. 65.) The financial condition of the corporation as of December 31, 1935, was as follows (R. 65):

ASSETS		LIABILITIES	
Cash	$562.28	Notes payable	$20,000.00
Accounts receivable	28,492.13	Capital stock	5,000.00
Land	4,632.82	Surplus	32,934.60
Building	29,597.80		
Depreciation reserve	(5,350.43)	Total	57,934.60
Total	57,934.60		

The accounts receivable included $20,688.71 owed to the corporation by the taxpayer; $1,031.70 owed by Julius Low; and $6,387.92 owed by the stockholders jointly. The item of $6,387.92 was withdrawn from the corporation by the stockholders and used by them, in whole or in part, for general household purposes.

The corporation had net earnings in 1935 of $869.78 and in 1936 of $979.52. At the close of 1935, the taxpayer owed his sister, Eda H. Low, $9,241. (R. 65–66.)

SUMMARY OF ARGUMENT

1. The corporation redeemed a portion of its outstanding stock in cancellation of debts owing to it by its stockholders. The Commissioner's determination that the redemption was essentially equivalent to the distribution of a taxable dividend is presumptively correct. The Board's finding of fact that the redemption was essentially equivalent to the distribution of a taxable dividend is supported by substantial evidence and therefore should be affirmed. The facts in this case exhibit almost every one of the criteria which have been deemed by the courts to be indicative that a redemption by a corporation of a portion of its capital stock comes within the scope of Section 115 (g).

2. The Board's finding of fact that the debt did not become worthless in 1935 is supported by substantial evidence and therefore should not be disturbed. The evidence supports the conclusion that the debt became worthless in 1934 and, in any event, the taxpayer failed to carry the burden of proving that the debt became worthless in 1935.

3. The evidence fully sustains the Board's finding of fact that L. B. Hirsch was not the head of a family in 1935 and 1936 and that the persons claimed to be dependent upon him were not so dependent, since they had ample independent means of support.

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ARGUMENT

I

The evidence fully sustains the Board's finding that the redemption of stock by the Hirsch-Weis Manufacturing Company in 1935 occurred at such time and in such manner as to made the redemption essentially equivalent to the distribution of a taxable dividend

Section 115 (g) of the Revenue Act of 1934 provides that if a corporation cancels or redeems its stock at such time and in such manner as to effect a distribution essentially equivalent to a taxable dividend, then the distribution shall be treated as a taxable dividend. We agree with the taxpayers that each case coming under Section 115 (g) must be decided on its own facts. The regulations have always stated that a determination of questions under this Section depends upon the circumstances of each case.[1]

In approaching the issues presented by this branch of the case, as well as those presented in the other

[1] See Treasury Regulations 69, Art. 1549; Treasury Regulations 74, Art. 629; Treasury Regulations 77, Art. 629; and Treasury Regulations 86, Art. 115-9. Section 115 (g) of the Revenue Act of 1934 is substantially the same as Section 115 (g) of the Revenue Act of 1932, Section 115 (g) of the Revenue Act of 1928, and Section 201 (g) of the Revenue Act of 1926. Compare Sections 201 (d) and 201 (f) of the Revenue Acts of 1921, c. 136, 42 Stat. 227, and 1924, c. 234, 43 Stat. 253, respectively. At the time the change was made in the 1926 Act it was pointed out that a corporation might, by the cancellation or redemption of its stock, effect a distribution to its stockholders without even resorting to the device of a stock dividend. H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939-1 Cum. Bull. (Part 2) 318); S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939-1 Cum. Bull. (Part 2) 344); H. Conference Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939-1 Cum. Bull. (Part 2) 361). The relevant extracts from these reports are printed in the Appendix, *post*, pp. 34-35.

questions here under consideration, it is necessary to keep certain fundamental propositions clearly in mind. In the first place the Commissioner's determination that this transaction came within the scope of Section 115 (g) is presumptively correct. *Welch* v. *Helvering*, 290 U. S. 111, 115. Secondly, it has been decided numerous times that the question whether a redemption or cancellation of stock is a transaction essentially equivalent to the distribution of a taxable dividend is one of fact. *Randolph* v. *Commissioner*, 76 F. (2d) 472 (C. C. A. 8th), certiorari denied, 296 U. S. 599; *Commissioner* v. *Champion*, 78 F. (2d) 513 (C. C. A. 6th); *Commissioner* v. *Babson*, 70 F. (2d) 304 (C. C. A. 7th), certiorari denied, 293 U. S. 571; see also *Brown* v. *Commissioner*, 79 F. (2d) 73 (C. C. A. 3d); *Goldstein* v. *Commissioner*, 113 F. (2d) 363 (C. C. A. 7th). Since the question is one of fact the decision of the Board of Tax Appeals must be affirmed if there is substantial evidence upon the record to support it (*Helvering* v. *Kehoe*, 309 U. S. 277; *Lauriston Inv. Co.* v. *Commissioner*, 89 F. (2d) 327 (C. C. A. 9th)), and the taxpayers come into this court bearing a very heavy burden.[2]

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[2] In almost every case in which this question has arisen the appellate court has affirmed the decision of the Board of Tax Appeals. See *Commissioner* v. *Babson*, 70 F. (2d) 304 (C. C. A. 7th), certiorari denied, 293 U. S. 571; *Randolph* v. *Commissioner*, 76 F. (2d) 472, 476 (C. C. A. 8th), affirming *Curlee* v. *Commissioner*, 28 B. T. A. 773, certiorari denied, 296 U. S. 599; *Commissioner* v. *Straub*, 76 F. (2d) 388 (C. C. A. 3d); *Commissioner* v. *Champion*, 78 F. (2d) 513, 514 (C. C. A. 6th); *Commissioner* v. *Cordingley*, 78 F. (2d) 118, 120–121 (C. C. A. 1st); *Brown* v. *Commissioner*, 79 F. (2d) 73, 74 (C. C. A. 3d); *McGuire* v. *Commissioner*, 84 F. (2d) 431 (C. C. A. 7th), certiorari denied, 299

The taxpayers argue that there is a lack of evidence indicating that the transaction was entered into as a scheme to avoid a declaration of a dividend by the corporation. As to this point it should be noted that the burden of proof was upon the taxpayers, and while the Board did not make any express finding as to the motives behind the transaction, the Board was apparently unimpressed by the suggested business necessity, for it pointed out in its opinion that the net effect was to render the relationship between current assets and current liabilities less favorable. There was a reduction in assets and no corresponding reduction in liabilities. But even if it be conceded, *arguendo,* that the taxpayers' motives were beyond reproach, the point is immaterial. The Government is not in this case necessarily concerned with the motives of the taxpayers but rather with the substantial effect of the transactions which they engaged in regardless of their purposes. There are many decisions to the effect that the test of taxability under Section 115 (g) is not one of motive alone. To be sure, evidence of a purpose of evade the

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U. S. 591; *Hill* v. *Commissioner*, 66 F. (2d) 45 (C. C. A. 4th); *Robinson* v. *Commissioner*, 69 F. (2d) 972 (C. C. A. 5th); *Commissioner* v. *Brown*, 69 F. (2d) 602 (C. C. A. 7th), certiorari denied, 293 U. S. 570; *Commissioner* v. *Rockwood*, 82 F. (2d) 359 (C. C. A. 7th); *Canady, Inc.* v. *Commissioner*, 76 F. (2d) 278 (C. C. A. 3d), certiorari denied, 296 U. S. 612; *Adler* v. *Commissioner*, 77 F. (2d) 733 (C. C. A. 5th); *Commissioner* v. *Quackenbos*, 78 F. (2d) 156 (C. C. A. 2d); *Commissioner* v. *Ahlborn*, 77 F. (2d) 700 (C. C. A. 3d); *Flanagan* v. *Commissioner*, 116 F. (2d) 937 (App. D. C.); *Goldstein* v. *Commissioner*, 113 F. (2d) 363 (C. C. A. 7th). Cf. *Parker* v. *United States*, 88 F. (2d) 907 (C. C. A. 7th); *Patty* v. *Helvering*, 98 F. (2d) 717 (C. C. A. 2d).

tax might be sufficient basis for a conclusion that the transaction came within this section of the Revenue Act, but the Government is not under the burden of proving such an illicit motive as a *sine qua non* of its case. Therefore, all the taxpayers' argument which is devoted to showing that there was a legitimate business purpose behind this transaction is interesting, if true, but beside the point. The following cases have held that motive is not the sole test. *Hill* v. *Commissioner,* 66 F. (2d) 45 (C. C. A. 4th); *Flanagan* v. *Commissioner,* 116 F. (2d) 937 (App. D. C.); *McGuire* v. *Commissioner,* 84 F. (2d) 431 (C. C. A. 7th), certiorari denied, 299 U. S. 591. Compare *Commissioner* v. *Cordingley,* 78 F. (2d) 118 C. C. A. 1st); *Patty* v. *Helvering,* 98 F. (2d) 717 (C. C. A. 2d).

To construe Section 115 (g) as applying only in the situation where the motive for the redemption of shares was to avoid taxation, would be to emasculate the Section and render it meaningless, for in the case where such a transaction is entered into with a motive to avoid the revenue laws, the transaction would be considered a taxable dividend regardless of this Section. *Gregory* v. *Helvering,* 293 U. S. 465. In the *Gregory* case the taxpayer received a corporate distribution under circumstances which complied exactly with the terms of a section of the applicable Revenue Act which provided that no gain should be recognized in that kind of transaction. Nevertheless, since the sole purpose of the taxpayer in that case was to avoid the receipt of a taxable distribution, the Supreme Court held that the taxpayer did not come within the scope of the section

providing for non-recognition of gain. So here Section 115 (g) must be construed as having greater content than merely proscribing transactions which are entered into for the purpose of cloaking a taxable distribution. The contention that the evidence does not show an intention to declare a dividend misses the fundamental issue here involved, for these taxpayers must be treated as having received a dividend if the transaction resulted in what was essentially equivalent to a dividend, regardless of their intention.

Even if it were true, contrary to the argument advanced above, that the presence of a genuine business purpose dictating a distribution and redemption rather than a simple dividend distribution in ordinary form constituted a relevant factor in applying Section 115 (g), it would of course not be determinative. At most the Board might appropriately weigh such a purpose in the balance with the other circumstances of the case. Furthermore, it does not appear that the claimed purpose really existed. True, the Board found that the auditors recommended liquidation of the shareholders' indebtedness to the corporation. Whether or not the suggestion as originally made contemplated payment of the debts in cash, which would have really improved the company's position, the record leaves wholly unexplained the obvious question of why the transaction took the form actually resorted to. A cancellation of the debts without redemption of the stock would have accomplished the same business purpose, reducing the ratio of current assets to current liabilities in no greater degree than the transaction as carried out. In either case the

debts would merely have been eliminated from the books. But of course the simple cancellation of the debts would have resulted in income to the taxpayers. The record does not disclose that this would have necessitated any different treatment of the minority shareholders than the plan adopted. Inasmuch as the taxpayers have failed to demonstrate in precisely what manner the mere cancellation of stock served any genuine corporate purpose, their main ground for reversal cannot prevail. And this is true, quite aside from the validity of our principal contention that the substantial effect of the transaction is determinative, regardless of the reasons for the form adopted.

We submit that there is an abundance of evidence upon this record to support the conclusion reached by the Board of Tax Appeals. The Court of Appeals for the District of Columbia recently had occasion to discuss Section 115 (g) in *Flanagan* v. *Helvering,* 116 F. (2d) 937. The court pointed out that while there is no exclusive test for determining when a transaction comes within the scope of Section 115 (g), various criteria have crystallized as being important in this determination. In the light of the discussion in that case, the following facts in this case are significant: First, this corporation did not manifest any policy of contraction. Secondly, the initiative for the corporate distribution came from a stockholder who needed funds to retire an indebtedness to the corporation. Thirdly, the corporation was operating at a profit and continued to operate at a profit. Fourthly, there had been no dividends paid for a substantial period of time, except those here in question. In this connection it is signifi-

cant that the by-laws of the corporation *required* the declaration of a dividend and that the past practice of the Hirsch brothers was to pay off their indebtedness to the corporation from dividends. We submit that that is exactly what they did here. Fifthly, the corporation had available a large surplus which could have been used for purposes of dividends. The taxpayer's argument that the corporation did not have available sufficient cash for the payment of the dividend is an insufficient answer. The entire transaction was a matter of bookkeeping only. It would have been simple to declare a cash dividend and offset it against the debts. In this connection it should be pointed out that where there is a surplus, Section 115 (b) requires that corporate distributions be allocated to the surplus. The decisions in *Patty* v. *Helvering, supra,* and *Flanagan* v. *Helvering, supra,* indicate that this factor alone is sufficient to require a conclusion that a redemption of stock is within Section 115 (g). Sixthly, there was no substantial change in the proportionate interests of the important shareholders in this corporation. With respect to this point, it should be noted that it is not necessary that a corporate distribution be made equally to each and every shareholder in order to bring that distribution into a class essentially equivalent to a dividend. *McGuire* v. *Commissioner,* 84 F. (2d) 431 (C. C. A. 7th), certiorari denied, 299 U. S. 591; *Brown* v. *Commissioner,* 79 F. (2d) 73 (C. C. A. 3d); *Hyman* v. *Helvering,* 71 F. (2d) 342 (C. C. A. 5th), certiorari denied, 293 U. S. 570; see also *Hudson* v. *Commissioner,* 99 F. (2d) 630 (C. C. A. 6th); *Allen* v. *Commissioner,* 117 F. (2d) 364 (C. C. A. 1st).

In the *McGuire* case the corporation had paid substantial dividends from 1902 to 1930, except for the years 1919 to 1922. It had accumulated a large surplus from 1925 to 1929 for the purpose of building a new factory. When it was decided in 1929 that times were not propitious for expansion, the corporation retired 80 of its shares. The court held that a distribution in retirement of the shares was a dividend within the meaning of Section 115 (g). It should be noted that there were excellent business reasons for the action of the corporaton and there was no indication of any motive to avoid the declaration of a taxable dividend. In addition, the court held that it was unimportant that one small shareholder did not participate in the distribution, and it was also considered unimportant that the two shareholders who did participate did not share according to the proportion of stock each owned. One of the shareholders had owned 85 shares and the other 94 shares, yet the corporation redeemed 40 shares for each shareholder.

In the *Brown* case, *supra,* shares were redeemed for only one shareholder, yet the transaction was held to come within the scope of Section 115 (g).

In the *Robinson* case (69 F. (2d) 972 (C. C. A. 5th)), there was a redemption of shares by the Coca-Cola Company. The court held that the redemption resulted in a taxable dividend even though the redemption privilege was not available to small stockholders. The court there said (p. 973): "It is enough that those entitled to participate had a right to demand a pro rata distribution of cash". That may be here paraphrased as follows: It is enough that those entitled to participate

had the right to demand a pro rata redemption of their shares. In this connection it should be noted that the right was explicitly recognized in the other shareholders. Thus, when Weis raised a question of his right to do the same thing, Max S. Hirsh conceded that Weis was entitled thereto.[3] The corporate minutes on this transaction speak of it as a privilege on the part of each and every stockholder. This effectively answers the taxpayers' contention that there was a disadvantage to the stockholders in this transaction. They certainly did not consider it disadvantageous but rather as a valuable privilege. Of course, the advantage did not consist in the mere redemption of the stock but in the cancellation of the debts.

The taxpayers' argument that the transaction was essentially a sale of the stock to the corporation has no foundation whatsoever in the record. Certainly the taxpayers would not have sold their stock at $100 to any outsider, for its book value was in excess of $125 per share exclusive of good will. Of course, when the stock went to the corporation at this price, the brothers Hirsch did not feel any poorer.

Against all these decisions in the various Circuit Courts of Appeals the taxpayers have been able to rely only upon what they contend are contrary decisions of the Board of Tax Appeals,[4] the very tribunal whose decision they here attack. Since the issue is one of fact for the Board, there is nothing to be gained by an extended review of the *Koch* and *Allen* cases.

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[3] See the statement of evidence. (R. 89–90.)

[4] *Koch* v. *Commissioner*, 26 B. T. A. 1025; *Allen* v. *Commissioner*, 41 B. T. A. 206.

II

The evidence fully sustains the Board's finding that the debt owed to Max S. Hirsch by Leo W. Seller did not become worthless in 1935

On this issue as on the other issues in this case the taxpayer is attempting to attack a finding of fact by the Board of Tax Appeals. The Board has found on substantial evidence that this debt did not become worthless in 1935 and that on the contrary it was worthless by the end of the preceding year. The Board's finding on this point must be accepted, provided that there is substantial evidence to sustain it. *Helvering* v. *Kehoe, supra; Lauriston Inv. Co., supra.*

In order for the loss to be deductible the taxpayer must show that he comes squarely within the terms of a provision permitting the deduction. *New Colonial Co.* v. *Helvering,* 292 U. S. 435. The leading case on the provision permitting the deduction of bad debts is *Avery* v. *Commissioner,* 22 F. (2d) 6 (C. C. A. 5th). In that case the court said (pp. 7–8):

> The reasonable interpretation of the law is that, in order to secure a deduction of worthless debts, they must be charged off in the year they are ascertained to be worthless. A man is presumed to know what a reasonable person ought to know from facts brought to his attention. A taxpayer should not be permitted to close his eyes to the obvious, and to carry accounts on his books as good when in fact they are worthless, and then deduct them in a year subsequent to the one in which he must be presumed to have ascertained their worthlessness. To do so would enable him to withhold deductions in his less

> prosperous years, when they would have little effect in reducing his taxes, and then to apply the accumulation at another time to the detriment of the fisc. This would defeat the intent and purpose of the law.
>
> Honesty of belief in the taxpayer is not conclusive, nor binding on the board. It is the province of the board to determine, on a review of all the facts and circumstances surrounding the particular debt sought to be deducted, whether the taxpayer knew or ought to have known its worthlessness in a prior year. If knowledge of the worthlessness of a debt sought to be deducted can thus be brought home to the taxpayer, it cannot be said that the worthlessness was ascertained in the subsequent year, when it is actually charged off.

The undisputed facts show that no payments were ever made on the principle of this note except for the amounts realized in the liquidation of the Garde-Seller Company (Leman-Seller Company). No payments of interest were made after September 1, 1930. In 1934, the only amounts realized from the liquidation were nominal. Only $10 was realized from January 1 to April 4 of that year; $36.92 was realized from April 5 to July 25, 1934; and $10 was realized from July 26 to October 15, 1934. It must have been apparent at that time to any reasonable man that there would be no further recovery from the liquidation of the defunct dress business. The taxpayer argues that he had expectation of some additional recovery from the outstanding accounts in 1934, but the letter of the attorneys who were liquidating the accounts, dated May 9, 1934, stated that the only remaining assets of the com-

pany were "collection items of uncertain value." Since the liquidation of these accounts had begun in June of 1932, certainly any reasonable man should have realized that any accounts which had not been paid by the end of 1934 were, from the practical point of view, valueless. Moreover the status of these accounts did not change in any way in 1935.

The taxpayer also places some reliance upon the fact that Seller testified that he considered that he had an equity in his home in Seattle of about $2,000. (R. 143.) But Seller's testimony indicates that he considered that he had that equity in 1935 as well as in 1934, and the mortgage thereon was not foreclosed until 1938. Therefore as regards this supposed asset of Seller's there was also no change from 1934 to 1935. In addition, Seller was married to Hirsch's sister, obviously testified in favor of Hirsch, and the credibility of the witnesses was an important factor for the Board to consider in determining the facts on this issue. 3 Paul & Mertens, Law of Federal Income Taxation, § 28.103.

Finally the taxpayer contends that Seller's illness in 1935 was the identifiable event which established the worthlessness of the debt in that year. But Seller had been working as a traveling salesman since the latter part of 1932 and in 2½ years he had not made a single payment upon the debt, although he testified that his net earnings in 1934 were about $2,400 to $2,800. (R. 143.) Since Seller had not made any payments when he had a fairly successful year in 1934, the Board was justified in concluding that a reasonable man would have had no expectation of any

future payments upon this debt. In any event the taxpayer failed to carry the burden of proving that the debt became worthless in 1935.

Since the question is fundamentally one of fact and the only issue before this Court is whether there was substantial evidence to support the Board's finding of fact, there is nothing to be gained by a detailed review of the cases cited by the taxpayer. Nevertheless it may be pointed out that there is nothing in *Lauriston Inv. Co.* v. *Commissioner, supra,* to support his position here. In that case this Court cited the *Avery* case, *supra,* with approval, and pointed out that the question was one of fact and sustained the determination of the Board. *Burdan* v. *Commissioner,* 106 F. (2d) 207 (C. C. A. 3d) (cited by the taxpayer as *Durdan* v. *Commissioner*), and *Stiver* v. *Commissioner,* 90 F. (2d) 505 (C. C. A. 8th), involved somewhat similar provisions of the law and in those cases also the decisions of the Board were affirmed. In *Dunbar* v. *Commissioner,* 119 F. (2d) 367 (C. C. A. 7th), the question was whether stock in a certain corporation had become worthless in 1934 or 1935. The court concluded that the taxpayer was justified in considering that his stock had value in 1934 since the corporation's assets in that year exceeded its liabilities by almost $100,000. There are no such facts here.[5]

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[5] Taxpayer is in error in his statement that Congress has provided relief in this type of situation by Section 3801 of the Internal Revenue Code (erroneously cited as Section 1871). See Maguire, Surrey and Traynor, "Section 820 of the Revenue Act of 1938," 48 Yale L. J. 719, 758 (1939).

III

The evidence fully sustains the Board's finding that L. B. Hirsch was not the head of a family and that his sister, brother-in-law, and their daughter were not dependent upon him

Again on this issue the taxpayer is attempting to upset the fact findings by the Board. Yet it seems clear that under the statutes and regulations the taxpayer is not entitled to these credits. He did not exercise family control. Furthermore, one cannot be the head of a family where the other persons claimed to be dependent upon him have independent means of support. *Ellis* v. *Commissioner,* 110 F. (2d) 954 (C. C. A. 5th). The Board found that the Lows were not dependent upon the taxpayer for support during either of the years involved. Certainly the alleged dependents here had independent means. In the first place the taxpayer owed his sister more than $9,000 directly, and she owned the home in which they lived. Secondly, the taxpayer owned the corporation, of which the Lows had almost a one-half interest, in excess of $20,000. From the practical viewpoint, therefore, the taxpayer was indebted to the Low family in the amount of more than $19,000. He may not take the equivocal position of claiming that the moneys that he contributed were absolutely necessary for their support when, had he paid his indebtedness, there would have been ample funds to support this family. The fair inference from the evidence is that to a large extent this entire group lived on the earnings and accumulated surplus of the Hirsch Investment Company; that instead of declaring

dividends to the stockholders the stockholders simply "borrowed" the money from their own corporation as they needed and wanted it.

The taxpayer suggests that the Lows could not realize upon the realty held by the Hirsch Investment Company. The argument is obviously specious. It was not necessary to sell the real estate. The stock held by Mr. and Mrs. Low in the Hirsch Investment Company could have been sold to the taxpayer himself for the very cash he claims to have used to support them.

The decisions of the Board of Tax Appeals cited by the taxpayer in *Fuhlage* v. *Commissioner,* 32 B. T. A. 22, and *Lowry* v. *Commissioner,* 11 B. T. A. 409, are distinguishable upon the fundamental point that there the claimed dependents had no independent sources of income.

As to the letter of the Internal Revenue agent which the taxpayer claims to be significant, it should be noted that this letter does not appear in the transcript of record and, moreover, it is fundamental that such statements by Internal Revenue agents do not bind the Commissioner. 5 Paul & Mertens, Law of Federal Income Taxation, § 53.08.

Upon no view of the evidence can it be claimed that the taxpayer is entitled to a $400 credit for his sister for she was over 18 years of age and there is nothing to indicate that she was mentally or physically defective.

CONCLUSION

The decision of the Board of Tax Appeals in each of these cases was correct and should be affirmed.

Respectfully submitted,

Samuel O. Clark, Jr.,
Assistant Attorney General.
J. Louis Monarch,
Bernard Chertcoff,
Special Assistants to the Attorney General.

July, 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year * * *.

* * * * *

(U. S. C., Title 26, Sec. 23.)

SEC. 25. CREDITS OF INDIVIDUAL AGAINST NET INCOME.

* * * * *

(b) *Credits for Both Normal Tax and Surtax.*—There shall be allowed for the purposes of the normal tax and the surtax the following credits against net income:

(1) *Personal exemption.*—In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500. * * *

(2) *Credit for dependents.*—$400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

* * * * *

(U. S. C., Title 26, Sec. 25.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out

of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

(U. S. C., Title 26, Sec. 115.)

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 25. CREDITS OF INDIVIDUAL AGAINST NET INCOME.

* * * * *

(b) *Credits for Both Normal Tax and Surtax.*—There shall be allowed for the purposes of the normal tax and the surtax the following credits against net income:

(1) *Personal exemption.*—In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500. * * *

(2) *Credit for dependents.*—$400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

* * * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (k)–1. *Bad debts.*—Bad debts may be treated in either of two ways—

(1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, * * *

* * * * *

ART. 25–4. *Personal exemption of head of family.*—A head of a family is an individual who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. * * *

* * * * *

ART. 25–6. *Credit for dependents.*—A taxpayer, other than a non-resident alien who is not a resident of Canada or Mexico (see section 213), receives a credit of $400 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (*a*) under 18, or (*b*) incapable of self-support because defective.

The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit.

ART. 115–2. *Source of distribution.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

* * * * *

ART. 115-9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other

cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 25-4. *Personal exemption of head of family.*—A head of a family is an individual who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. * * *

ART. 25-6. *Credit for dependents.*—A taxpayer, other than a non-resident alien who is not a resident of Canada or Mexico (see section 214), receives a credit of $400 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (*a*) under 18, or (*b*) incapable of self-support because defective.

The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit.

Congressional Committee Reports relating to Section 201 (g) of the Revenue Act of 1926:

H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939-1 Cum. Bull. (Part 2) 318):

PARTIAL LIQUIDATION

Section 201 (f). It has been contended that under existing law a corporation, especially one

> which has only a few stockholders, might be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example: Assume that two men hold practically all the stock in a corporation, for which each had paid $50,000 in cash, and the corporation had accumlated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders, for cash, one-half of the stock held by them and cancel it without making the stockholders subject to any tax. Yet this action, in all essentials, would be the equivalent of a distribution through cash dividends of the earned surplus. The amendment proposed to this subdivision is intended to make clear that such a transaction is taxable.

Substantially the same statement is made in S. Rep. No. 52, 69th Cong., 1 st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 344), and H. Conference Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939–1 Cum. Bull (Part 2) 361).

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